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Review of the issue of establishing an operational reserve

Summary

The present report was prepared in response to Executive Board decision 2001/7 (E/ICEF/2001/6), in which the Board decided that UNICEF should continue its current financial management practice based on management of its short-term liquidity requirements on a cash-flow basis and should not establish a funded operational reserve. The Board decided to maintain the issue under review and consider it further during 2003.

Under its current policy, established by the Board in 1987, UNICEF must maintain year-end cash balances of regular resources income equal to approximately 10 per cent of the following year's regular resources income. The liquidity requirement is limited to regular resources income because of the self-funding requirement for other resources. Since the issue of an operational reserve was last discussed by the Executive Board in 2001, UNICEF has exceeded the 10-per-cent liquidity requirement, as it has done since the measure was established. In addition, UNICEF has met the informal liquidity ratio reported in its financial statements.

While an operational reserve can provide a short-term response mechanism to address an unforeseen shortfall in receipts and income, and can also afford an opportunity to earn marginally increased interest income through longer-term investments, an operational reserve creates a balance sheet asset at the expense of funding programmes, and may engender increased costs if it becomes necessary to break long-term investment commitments to utilize the funds.

The Executive Director therefore **recommends** that UNICEF continue to manage its liquidity in accordance with the liquidity requirement approved by the Executive Board and that it not establish a funded operational reserve.

* E/ICEF/2003/10.

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Introduction

1. The question of establishing an operational reserve was first raised by the Advisory Committee on Administrative and Budgetary Questions in 1999, in the context of its review of the biennial support budget for 2000-2001. The Advisory Committee recommended, and the secretariat agreed, that "UNICEF [would] analyse the advantages and disadvantages of establishing an operational reserve for both regular and other resources, taking into account the experience of other funds and programmes in this regard ... and the pertinent observations of the Advisory Committee ..." (E/ICEF/1999/AB/L.10, para. 9).

2. The report, "Establishment of an operational reserve" (E/ICEF/2001/AB/L.3) was presented to the Board at its first regular session of 2001, accompanied by a report of the Advisory Committee (E/ICEF/2001/AB/L.4), which noted that:

(a) The secretariat report analysed the advantages and disadvantages of establishing an operational reserve for both regular and other resources, taking into consideration the existing financial management framework and liquidity policy of UNICEF;

(b) The last time the Executive Board had reviewed the matter was in 1987, when the existing liquidity requirement was established. Under that requirement, UNICEF must maintain year-end cash balances of regular resources income equal to approximately 10 per cent of the following year's regular resources income. The liquidity requirement has been limited to regular resources income because of the self-funding requirement for other resources;

(c) The ratio between regular resources and other resources has changed over time with an ever increasing share being represented by other resources. Also, an increasing share of regular resources income is derived from private sources;

(d) The Executive Board should maintain the issue of establishing an operational reserve under review.

3. In its ensuing decision 2001/7 (E/ICEF/2001/6), the Executive Board decided that UNICEF should continue its current practice based on management of its short-term liquidity requirements on a cash-flow basis and should not establish a funded operational reserve. The Board decided to maintain the issue under review and consider it further at its first regular session of 2003, taking into account the report of the Advisory Committee on the biennial support budget for 2002-2003 and the report of the United Nations Board of Auditors for the biennium 2000-2001. The issue was subsequently allocated to the agenda of the 2003 annual session.

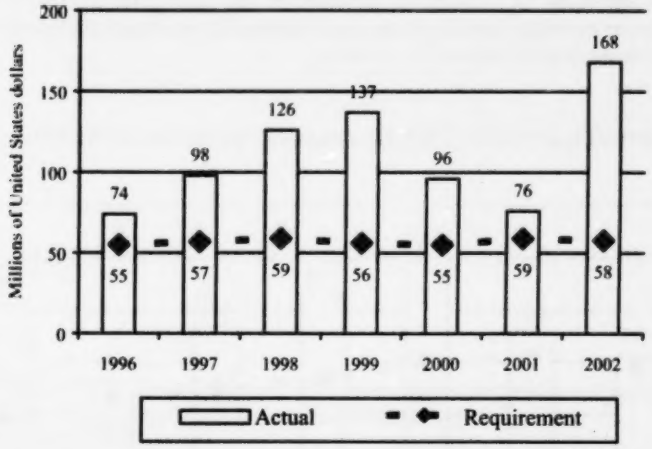
4. The Advisory Committee did not comment directly on the issue of the operational reserve in its report on the biennial support budget for 2002-2003 (E/ICEF/2001/AB/L.11). The Board of Auditors made no recommendation on the matter in its report on the UNICEF financial report and audited financial statements for the biennium ended 31 December 2001 (A/57/5/Add.2).

The question of establishing an operational reserve

5. Since its inception, UNICEF has not had a funded operational reserve, with the Executive Board opting instead to endorse a cash management approach to liquidity.

In 1987, the Board approved the existing policy which is outlined in paragraph 2 (b) above. The requirements of the policy have been met consistently since it was established. Table 1 below illustrates the experience for the period 1996 to 2002. Based upon the existing liquidity policy, UNICEF should have been holding at least $58 million in regular resources funds at the end of 2002; in fact, it was holding $168 million. The dramatic upturn in liquidity in 2002 resulted from foreign exchange gains associated with a weakened United States dollar and increased private sector income partly attributable to a one-time legacy contribution.

Table 1
Regular resources liquidity requirement, 1996-2003



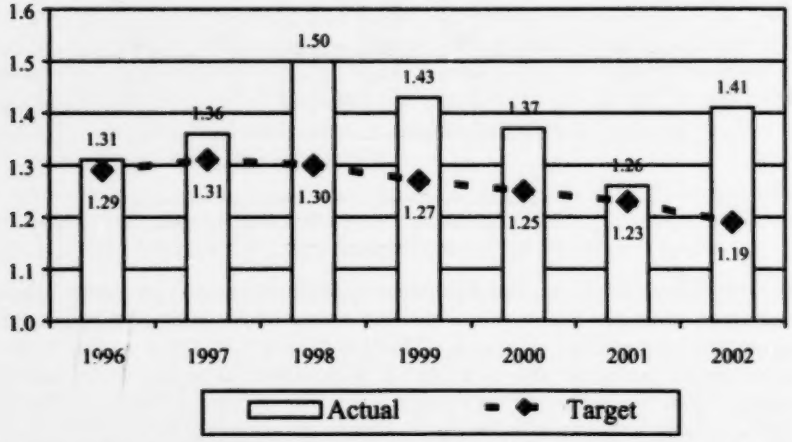
6. The annex to this document provides updated information on regular resources and other resources income since the last report to the Executive Board on the question of the operational reserve (E/ICEF/2001/AB/L.3). Other resources income continues to dominate and is expected to continue to represent an increasing proportion of income during the coming years. The increase in regular resources in 2002 was dramatically affected by a significant one-time legacy and from the foreign exchange impact of a weakening United States dollar. The composition of regular resources income is expected to revert in 2003 to the historical pattern with slowly increasing government contributions and an increasing trend in private sector income.

7. An additional measure of liquidity is reported in the financial statements. While not required by the Executive Board, this is an additional useful measure for judging the ability of UNICEF to meet its short-term cash requirements. This liquidity measure is based upon the ratio of short-term assets to short-term liabilities. Because other resources income is received in advance of expenditures, the liquidity ratio for other resources would be expected to be 1:1. For regular resources income, the liquidity ratio should be at least 1:1 but prudent financial management principles would dictate a ratio of 1.5:1. The ratio that is presented in the financial statements is a blend of the other resources and regular resources liquidity, which thus changes in relation to the relative weightings of regular and

other resources. For example, when other resources are equal to regular resources, this target weighted average ratio would be 1.25:1. As can be seen from table 2 below, there is some minor fluctuation in the target weighted average liquidity ratio but its variations are relatively smooth over a multi-year span.

8. Since the issue of an operational reserve was last discussed by the Executive Board in 2001, UNICEF has exceeded the 10-per-cent liquidity requirement established by the Board, as it has done since the measure was established. In addition, UNICEF has met the informal liquidity ratio reported in the financial statements. At the end of 2002, the weighted average liquidity ratio target, calculated on the basis of the regular resources/other resources split for the year, was 1.19 and the actual liquidity ratio was 1.41. The decline in the ratio from 1998 to 2001 was the result of a conscious decision by the secretariat to ensure, to the maximum extent possible, that resources are employed to meet the objectives of the organization through programmes for children.

Table 2
Liquidity ratio as reported in UNICEF financial statements, 1996-2002



9. UNICEF manages its liquidity on a daily basis in order to ensure the proper balance of its investment portfolio and the management of receipts and disbursements, to provide adequate funding for its offices around the world and to maximize the return on its investments. The Division of Financial and Administrative Management (DFAM) is responsible for the ongoing monitoring of the organization's banking and internal financial management systems.

10. An operational reserve would be one possible means of addressing sudden short-term events affecting programmes, but it would be merely a stop-gap measure that could be employed pending a longer-term correction of the organization's financial plan. A liquidity requirement, if properly managed on an ongoing basis, provides the same kind of short-term reaction mechanism.

11. The continuing commitment of donors to the UNICEF multi-year funding framework is improving this process as part of the organization's liquidity management. In addition, the National Committees for UNICEF have initiated more

regular transfers of funds, helping to smooth out cash flow and allowing for better financial planning and increased interest income via longer investment periods.

12. Of seven international organizations surveyed, only three had operational reserves (the International Labour Organization (ILO), the United Nations Development Programme (UNDP) and the World Food Programme (WFP)), only one of which, UNDP, included a provision for an other resources operational reserve. These three operational reserves for regular resources range from $21 million to $149 million and in all cases equalled roughly 5 per cent of total receipts for 2001. If UNICEF were to create an operational reserve based upon this principle, approximately $70 million would have to be set aside.

Table 3
Operational reserves of United Nations and other agencies

	Regular resources operational reserve	*Total receipts*
Agency	*(In millions of United States dollars)*	
UNDP	149	2 860
ILO	21	416
WFP	57	1 356
United Nations	-	7 000
FAO[a]	-	551
WHO[b]	-	1 179
OECD[c]	-	250

[a] Food and Agriculture Organization of the United Nations.
[b] World Health Organization.
[c] Organisation for Economic Cooperation and Development.

13. On the positive side, an operational reserve can provide a short-term response mechanism to address an unforeseen shortfall in receipts and income, and can also afford an opportunity to earn marginally increased interest income through longer-term investments.

14. On the other hand, an operational reserve creates a balance sheet asset at the expense of funding programmes, and may engender increased costs if it becomes necessary to break long-term investment commitments to utilize the funds.

15. On balance, the secretariat continues to believe that an operational reserve is not required, given the increased cooperation of its funding partners via the multi-year funding framework and the quarterly remittances from National Committees, and the organization's enhanced ability to manage and control cash management using its integrated computer information systems.

Recommendation

16. The Executive Director **recommends** that UNICEF continue to manage its liquidity in accordance with the liquidity requirement approved by the Executive Board and that it not establish a funded operational reserve.

Annex

Change in proportion of regular and other resources income, 1993-2002

(In millions of United States dollars)

Year	*Regular resources*	*Other resources*	*Total income*	*Percentage of other resources to total income*
1993	509	357	866	41
1994	535	471	1 006	47
1995	537	474	1 011	47
1996	551	393	944	42
1997	547	355	902	39
1998	571	395	966	41
1999	589	529	1 118	47
2000	563*	576	1 139	51
2001	551*	674	1 225	55
2002	709*	746	1 455	51

Regular resources income, 1993-2002

(In millions of United States dollars)

Year	*Government contributions*	*Private sector*	*Other income*	*Total regular resources income*	*Private sector share of regular resources income (%)*
1993	358	121	30	509	19
1994	361	129	45	535	21
1995	354	145	38	537	25
1996	364	151	36	551	27
1997	358	162	27	547	29
1998	344	182	45	571	32
1999	344	207	38	589	34
2000	343*	165	55	563	29
2001	351*	164	36	551	29
2002	368*	282	59	709	40

* Government contributions recorded at the gross level in order to be consistent with historical data.

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The UNICEF recovery policy

Introduction

1. At its first regular session in 2003, the UNICEF Executive Board reviewed "The UNICEF recovery policy" (E/ICEF/2003/AB/L.1) and "The UNICEF recovery policy: Report of the Advisory Committee on Administrative and Budgetary Questions" (E/ICEF/2003/AB/L.2), and requested UNICEF to hold consultations and revert to the Executive Board at its annual session in 2003 (E/ICEF/2003/9 (Part I), paragraph 59).

2. UNICEF held various consultations with the regional groups, National Committees and, in some cases, bilateral consultations. The areas discussed are summarized below.

Underlying principles of the recovery policy

3. The following are key areas of consensus on the underlying principles of the recovery policy:

(a) Other resources programmes should be channelled to priority areas approved in the medium-term strategic plan (MTSP);

(b) In view of the stagnating level of contributions to regular resources, it is essential, to the extent possible, that regular resources should not be used to subsidize other resources-funded programmes. Continued subsidization would cut into the core capacity of UNICEF required to sustain overall UNICEF programmes;

(c) The recovery policy should be structured to encourage reduction in transaction costs while keeping the mechanism simple and transparent to administer.

* E/ICEF/2003/10.

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How key concern areas are dealt with in the revised proposal

4. The following are key areas of concern as expressed by the delegates.

Harmonization

5. Almost all delegations stressed the importance of harmonization and a common United Nations model. As indicated in the Secretary-General's report on the Joint Inspection Unit (JIU) study, "Members of the United Nations System Chief Executives Board for Coordination generally accept the findings and recommendations contained in the report and acknowledge the need to monitor, on a system-wide basis, emerging policy questions and procedures and to keep under review the overall management of extrabudgetary resources within the United Nations system." (A/57/442/Add.1, Summary). It should be pointed out that the proposed UNICEF recovery policy is in line with the recommendations contained in the JIU report. UNICEF has initiated discussions on the JIU paper among United Nations agencies and will pursue common methodology through the Management Group of the United Nations Development Group (UNDG).

Thematic fund-raising

6. Throughout the consultations, it was evident that delegations, in general, support the concept of a thematic, multi-country fund-raising approach, and feel that the recovery policy ought to be formulated to channel the other resources to the MTSP priorities. For fund-raising purposes, donors would be encouraged to provide funding for the thematic areas at global, regional and country levels. There would be five MTSP priority thematic areas and one for humanitarian assistance. For example, all the country thematic contributions for girls' education will be pooled to fund the activities for girls' education of the country programme approved by the Executive Board. Individual tracking of each contribution will not be established in the financial system as consolidated reporting will be given for the specific theme. This will reduce the transactional costs of maintaining and reporting based upon individual donor contributions. Therefore, it is proposed that a reduction of 3 per cent on the recovery rate would be given to the thematic contributions.

Private sector fund-raising

7. In the recovery policy paper, it was proposed that the recovery rate for the private sector fund-raising in the programme countries will be maintained at 5 per cent in view of the difficult economic situation and fluctuating exchange rates. For other private sector fund-raising from National Committees, foundations, non-governmental organizations and individuals, in view of the competitive fund-raising markets, and since such contributions are booked on a cash basis, it is proposed that the recovery rate will be 5 per cent for thematic contributions, and 7 per cent for non-thematic contributions. As National Committees typically build their fund-raising base for regular resources from the contribution to other resources, this will provide an environment for increased fund-raising capability in both regular resources and other resources.

Simplification of the proposal

8. Most delegations would like to see a simplification of the original proposal while still providing incentives for low transaction costs. It is recommended that for contributions from government and intergovernmental sources , the reduction of 3 per cent for thematic contributions, 2 per cent for contributions with 90 per cent paid up front, and 1 per cent for contributions over $500,000 be offered. Table one below gives the possible situations depending on the conditions of the contribution. For small value contributions, which are usually paid up front, donors would be encouraged to provide for thematic areas to reduce the transaction costs. In this case, the recovery rate would be 7 per cent.

Table 1 Recovery rate schedule

			Reduction percentage (%)			Total	Recovery
			S	T	P	Reduction	rate
Contribution less than $500,000	Non-thematic	Tranches	0	0	0	0%	12%
		90% paid upfront	0	0	2%	2%	10%
	Thematic	Tranches	0	3%	0	3%	9%
		90% paid upfront	0	3%	2%	5%	7%
Contribution above $500,000	Non-thematic	Tranches	1%	0	0	1%	11%
		90% paid upfront	1%	0	2%	3%	9%
	Thematic	Tranches	1%	3%	0	4%	8%
		90% paid upfront	1%	3%	2%	6%	6%

S=size T=Thematic P=minimum 90% paid up front

Interest income on other resources cash balances

9. As indicated in the recovery paper, ACABQ has pointed out that in light of potential fluctuations in the pattern of receipts and disbursements, as well as fluctuations in exchange rates and interest rates, it would not be prudent, as a matter of policy, to rely on interest income to cover shortfalls in support costs recovery. Hence, this proposal continues not to reduce the recovery rate to take into account interest income, which is currently estimated to be around 2 per cent. Interest income earned on other resources will continue to be recorded as miscellaneous income in regular resources as stipulated in UNICEF financial regulation 11.4. However, to take into account the lead-time between the receipt of cash income and actual spending, during which time the interest income will accrue, a reduction of 2 per cent is proposed as indicated under paragraph 8 above.

United Nations reform and new funding modality

10. New funding modality and procedures may emerge from the UNDG discussions on United Nations reform. Until this discussion is finalized, it is difficult to foresee what will be the support activities and associated support costs required. Hence, it is proposed that the Executive Director be authorized to accept such funds in line with the principles mentioned above, with a rate to be determined on the basis of support required, and report back to the Executive Board.

Recommendation

11. The Executive Director *recommends* that the Executive Board adopt the following draft recommendation:

The Executive Board,

Having reviewed the UNICEF recovery policy, as contained in document E/ICEF/2003/AB/L.1, and the document E/ICEF/2003/AB/L.5 submitted at the present session,

1. *Approves* the principles that other resources support the medium-term strategic plan priorities and that regular resources should not subsidize the support costs for other resources programmes, and *encourages* a procedure that will reduce transaction costs for other resources programmes;

2. *Endorses* that the methodology, as described in paragraph 13 of document E/ICEF/2003/AB/L.1, be used. The methodology will be reviewed in light of the harmonization discussion among the United Nations agencies;

3. *Takes note* of the calculation shown in document E/ICEF/2003/AB/L.1, annex II, on the basis of methodology and 2000-2001 actual expenditure which yields a rate of 12 per cent;

4. *Authorizes* the Executive Director to apply the following rates to all new agreements to be signed after Executive Board approval of the revised policy:

(a) 5 per cent for all funds raised from the private sector in the programme countries;

(b) For other private sector funds, 5 per cent for thematic contributions and 7 per cent for non-thematic contributions;

(c) For other contributions, the reduction of 3 per cent for thematic funds, 2 per cent for 90 per cent up-front payments, and 1 per cent for contributions over $500,000;

(d) For new funding arrangements under United Nations reform, rates will be determined in accordance to specific support activities required from UNICEF. This will be reported back to the Executive Board;

5. *Requests* the Executive Director to report to the Executive Board on the experiences of the recovery policy in the 2006-2007 biennium support budget document.